THE RELATION OF THE NEW CURRENCY ACT TO THE WORK OF COMMERCIAL PAPER HOUSES

The function of the commercial paper house is, on the one hand, to supply credit to business houses by discounting their notes, and, on the other hand, to furnish to banks which have unemployed funds a liquid, quickly maturing form of investment. The necessity for so obtaining credit and the demand by banks for a liquid form of investment are vital alike to business and banking, and will exist under any system of currency. The effect of the new law on the work of commercial paper houses will be at most a change only of form, or in method of doing business, and not in the nature of the service performed.

In the present practice of commercial paper houses advances of funds are made by the discounting of promissory notes. The money so obtained is used by the borrower in the purchase of goods and in preparing them for market. When the goods are marketed and paid for, the proceeds of their sale enable the borrower to pay his notes.

The term "commercial paper" originally indicated notes or acceptances given in settlement for goods bought; but the commercial practice of settling bills by notes has long since been discontinued in this country owing to the offering by wholesalers of substantial discounts for payment in cash. This practice is so general that a concern which does not discount its bills is regarded as being in a strained financial position. Discounting has become in this country the touchstone of credit standing. To such an extent is this true that a merchant who fails to discount his bills cannot possibly withstand competition. Indeed, in many lines the cash discount constitutes the entire margin of net profit. The result is that most concerns borrow from their banks or brokers on their promissory notes in order to take advantage of the cash discounts. It is apparent from this that such notes are issued against goods which the borrower has purchased, and their payment depends upon his properly marketing his goods. In the case of

bills receivable, the merchant who discounts them with his bank or broker is obtaining funds on goods which he has sold; the proper marketing of the goods upon which the bills are created will depend upon the ability of another merchant than the one who obtains the bank credit on them.

The extending of merchandise credits when the cash discount test is removed can be abused to a greater degree than direct bank loans. The merchant is always eager to sell, and a customer who need not pay cash may be tempted to buy beyond his means, but the bank which has fixed his line of credit has thereby set the limit of his purchases. The danger of overexpanded credit is thus checked at the source.

There has been some apprehension that under the new law an attempt was to be made to restore the old practice and to favor the use of indorsed bills receivable as against simple promissory notes. For the reason stated, this seems to me to be an undesirable change and one which would inevitably tend toward undue expansion of credit. However, if the practice of obtaining credit by discounting indorsed bills receivable is to take precedence over the use of promissory notes, and the latter instrument is to be gradually abandoned, the work of the commercial paper house will consist of buying and selling indorsed bills receivable instead of promissory notes. This will in no way affect its general function.

Aside from any change in the character of the loans dealt in by the commercial paper house, it is quite evident that its method of operation will be affected in many ways. I shall not attempt to trace the gradual changes as the law is put into effect step by step, but rather shall consider conditions after the law is in full swing and operation.

In considering the relation of the new law to the commercial paper house, it is well to notice briefly the features which more particularly affect the paper-buying ability of banks. The first of these is the smaller reserve required. After the three-year interim allowed for the gradual shifting of reserves, the reserve requirements for country banks will have been reduced from 15 per cent to 12 per cent; for reserve city banks, from 25 per cent to 15 per cent; and for central reserve banks from 25 per cent to 18 per cent on all demand

deposits; and the reserve required against time deposits will be 5 per cent in each case. It will be noticed that under the new act a sharp distinction in reserve requirements is made as between time and demand deposits, only 5 per cent being required on time deposits, whereas under the old act the same reserve was required against time as against demand deposits.

The second important feature is the fact that reserves must be kept in a bank's own vaults or in the Federal Reserve Bank of its district. Deposits by country banks in reserve or central reserve cities, and deposits made with central reserve cities by banks located in reserve cities will no longer be counted as part of the depositing bank's reserve.

The third feature is the discontinuance of the use by country banks of reserve and central reserve banks as their collecting agents, and, it is hoped, the eventual discontinuance, in large measure, of the whole practice of banks using other banks for this purpose. Under the new act, banks will deposit items drawn on banks in their own district directly with the Federal Reserve Bank, and such items will thus automatically become a part of their reserve, the Federal Reserve Bank in turn charging them up to the member bank on which they are drawn. While no provision has yet been made for Federal Reserve Banks to receive items on member banks of another district, it is believed that such an arrangement will eventually be completed.

The fourth and most important of all these features is the rediscounting function of the Federal Reserve Bank. The new act provides that

> upon the indorsement of any of its member banks . . . . any federal reserve bank may discount notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used or are to be used for such purposes.

Heretofore, in the older and more thickly populated districts of the United States, it has been the exception rather than the rule for good banks to rediscount paper, and the fact that they never have rediscounted has been a matter of pride with many banks. Especially has this been true of banks in reserve and central reserve cities,

which have disliked exceedingly to show an item of rediscount on their published statement; but with an official government sanction on this procedure, rediscounting will become a perfectly normal incident of the banking business.

Let us now consider the effect of the new law on the country bank. It is apparent that the decrease in legal reserve, in itself, necessarily means larger resources available for loans. The increase in loanable funds will be even greater than the amount represented by the percentage of reduction in the reserve actually required, because under the present system conservative banking practice has necessitated the maintaining of reserves in excess of the legal requirements. Under our present system, the limits of credit allowed to borrowing banks, other credit requirements being satisfied, are in a large measure determined by the amount of their average balances in reserve and central reserve cities. As a result many country banks are compelled to keep large balances with their reserve city correspondents at certain seasons, as a compensation for the rediscounting accommodations which they are compelled to seek of these correspondent banks during other seasons of the year when their local demand is strong, as, for instance, during the crop-moving period. Under the operation of the new law, the necessity for these balances will have been obviated, because the Federal Reserve Bank will rediscount for its member banks in proportion to their legitimate needs rather than in proportion to the amount of their balance.

Country banks have also carried large balances with reserve and central reserve banks in order to get favorable terms on collections, the larger balance compensating the city bank for the trouble and expense of collecting. The Federal Reserve Bank will now act as a clearing-house and will accept for immediate credit checks on other member banks and drafts on other Federal Reserve Banks at par.

Many country banks have heretofore carried a large balance with reserve and central reserve banks as a general measure of prudence in order to be prepared for emergencies. They will not feel the same necessity under the new law because they will know that in an emergency they can immediately rediscount at the Federal Reserve Bank.

It is apparent from all this that the country banks will have a much larger volume of loanable funds than at present, and will purchase commercial paper even more extensively than now.

Furthermore, commercial paper is likely to supplant certain less liquid forms of investment now held by country banks. Many banks which carry a large amount of loans secured by stock exchange collateral, which will be ineligible for rediscount, will find it advisable to carry a larger proportion of convertible paper. Many of them in the past have carried bonds as an investment on the theory that they are always marketable. While it is true that there is always a market for high-grade bonds, it has usually been the case that at times when such banks have had to realize on their bonds the rates on money have been high and the price of bonds correspondingly low. This experience has proved costly to many banks. But if a bank should buy paper even during a period of very cheap money and should be obliged to rediscount it during a period of very high money, the loss would be inconsequential, since the paper would have only a short time to run.

The effect of the new act on the city bank is more difficult to determine. It is evident, however, that just as in the case of the country bank its loaning power will increase to the extent that its legal reserve requirements are decreased. It will also have an increased loaning power, from the fact that it will be able to include in its reserve a large amount of funds which are now not available for that purpose. This has particular reference to so-called "transit items"—that is, checks drawn on out-of-town banks for which the depositor has received credit, but which the receiving bank is obliged to send out for collection. In the ordinary course of business several days elapse before returns are received on these items, and the bank holding them is not allowed in the meantime to treat them as part of its reserve. In the case of large Chicago banks, these so-called "transit items" amount to many millions of dollars. Under the new act the bank will deposit such items with the Regional Federal Reserve, where they will be counted as part of its reserve.

The loaning power of banks in reserve cities will also be increased to the extent that the banks will no longer find it necessary to keep

balances with other banks to obtain collection service. City banks now have large funds tied up in deposits with each other. The Federal Reserve Banks will collect and remit for member banks, thus eliminating the necessity for such deposits.

These increases of loaning power, however, will be more than offset by decreased loaning power as a result of probable withdrawal of country deposits. In our consideration of the effect of the new act upon country banks, we have fully set out the reasons why country balances will be greatly diminished. This decrease of country deposits will undoubtedly come about very gradually, however, and there will always be a considerable quantity of such deposits. It will take the country banker some time to accustom himself to the lower reserves permitted by the new act, and instead of keeping these surplus reserves with the Federal Reserve Bank he will naturally keep them in the city bank, because he will thus get interest on them. Moreover, many country banks will want some service from their city correspondent not obtainable from the Federal Reserve Banks, such as the taking of surplus lines of their customers without indorsement, the supplying of general credit information, the assistance of the city bank in the investment of their funds, and other incidental services. To obtain such service some deposits will be maintained.

It is generally true of city banks doing a commercial business that their direct loans to customers exceed their loanable funds derived from their own capital and their individual deposits. This will probably be true, even with the decreased reserves required under the new act. The deposits by country banks have served to provide the necessary funds. It follows that a substantial reduction in country balances must be followed by a large reduction in loans. This will be accomplished in one or more of the following ways, or more probably by all of the following ways: (1) the contraction of loans to customers, (2) the cessation of purchases of commercial paper, (3) rediscounting with the Federal Reserve Bank.

The net result of all this is that city banks which have heretofore been large purchasers of commercial paper will have little or no surplus funds to invest in the purchase of commercial paper; in

fact, commercial paper houses will probably have to extend larger lines of credit to their customers to offset the decreased lines obtainable at the banks. It is evident, however, that the total loanable funds of the entire country will be substantially increased, so that the decreased city demand for paper must be more than offset by the increased country buying of paper. It is thus quite apparent that the commercial paper houses will have to take cognizance of the country banks as furnishing the real market for open market purchases, and they will have to organize their work accordingly.

It is also likely that the act will open a new field for the commercial paper house—namely, that of dealing in bank rediscounts. The rate of discount in different Federal Reserve Banks will differ according to the demand for money in each particular district. For example, it is quite probable that at some seasons of the year the discount rate of the Federal Reserve Bank serving the banks in Texas might be 6 per cent, while that of the Federal Reserve Bank in Chicago would be only 4 per cent. It would be entirely within the province of the commercial paper house to rediscount paper bearing the indorsement of Texas banks at a rate slightly below the rate fixed by the Federal Reserve Bank of the Texas district, and place this paper with banks in Illinois. It would simply be another opportunity for the broker to exercise his function of acting as a medium between borrower and lender, and thus tending to lessen the disparity in rates.

It is evident from the foregoing that there will be a largely increased supply of loanable funds. There is nothing in the act, however, to create any new or unusual demand for funds, so that it is a fair conclusion that the effect of the new act will be to lower rates of interest in general, and particularly rates on commercial paper.

On the whole, the general work of the commercial paper house will require very little change to accommodate itself to the new law. Credit investigation will be the same, and methods of marketing paper will remain substantially as at present. The only important change that will follow will be in the location and distribution of the market for absorbing the paper.

ROBERT C. SCHAFFNER

CHICAGO, ILL.